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It Appears the U.S. Economy Just Entered Recession

by Richard Morey

This report begins with a commentary on the financial media. This morning (Dec. 2) manufacturing numbers came out showing the manufacturing recession increasing in severity. Bloomberg television immediately brought out three "expert" analysts to explain to their audience the economy is actually continuing to grow and is basically healthy.

The second speaker said it's a little-known fact that productivity growth has been roaring. Here is a chart of productivity growth in the United States. Note it dropped below zero in the third quarter, falling 0.3%.

In reality, the economy is not only neither healthy nor growing, it now looks as if we have just entered recession. When attempting to analyze this statement, I would have you keep two facts in mind:

1. Even though I have been exceptionally negative about the economy and markets, until now I have not believed we were actually in a recession. We've been teetering on the edge basically the entire last decade, but this may have been the first time I've actually seen what sure looks like a recession – now.

2. Economic growth as measured by GDP by the Bureau of Economic Analysis, along with the financial media, is usually at least 9 months slow in recognizing we are in a recession.

An Inverted Yield Curve

We have had inversions in the yield curve for well over a year. Every time the yield curve has inverted since 1955, recession has followed sometime in the following 12-24 months. Check.

An inverted yield curve is the one perfect indicator of coming recession. An inverted yield curve does not, however, tell us exactly *when* we will have entered said recession. For that we look first at exactly two facts:

1. Retail spending has had zero growth since mid-September. The only thing keeping up the economy was retail spending. Retailer expectations for the holiday season have also been dropping and are unusually negative right now.

2. Business spending has been dropping for over the last three quarters.

Both of these are indisputably true statements, so it seems to me that's about all the analysis we need to say the economy has been contracting since September. This doesn't mean it's going to fall off the cliff tomorrow. It does mean the path is clearly downwards for the economy. And yes, that is a cliff up ahead. As we approach the cliff, the economy will of course be going down much faster.

My prediction is that we go over the cliff in 9 months. This lines up with the understanding that, assuming I am correct, and we just entered recession, the headlines will read "U.S. in Recession" in approximately 9 months. With the real economy actually in a deepening recession throughout (plus an earnings recession already well over a year-old today), I would expect to see stocks drop perhaps 20%-30% over the next 9 months. Then they too will go over the cliff.

This means I believe the economy and markets could bounce around for the next nine months, but the overall trajectory for both will now be down. We are now on the downhill side of this economic cycle. It's a long, long way down.

Please note what I just wrote goes directly against the work of Fasanara Capital. They have given me a 30-page report proving the cliff is at most one month ahead of the first break in the corporate junk debt markets, in Europe or the United States. Jeff Snyder at Alhambra, and the ex-Chief Economist of the Bank of International Settlements, William White, have recently presented the same analysis. Along with Lacy Hunt, John Hussman, and Albert Edwards, Fasanara Capital is someone with whom I always agree. They are teaching me, not the other way around (though I do believe I could teach Lacy Hunt something about Treasury investing – but never on economics).

Even though I therefore expect the geniuses at Fasanara to be correct, I'm sticking with my prediction the crash phase will begin in nine months and not in the first few days and weeks after one of several key debt and equity markets first crack.

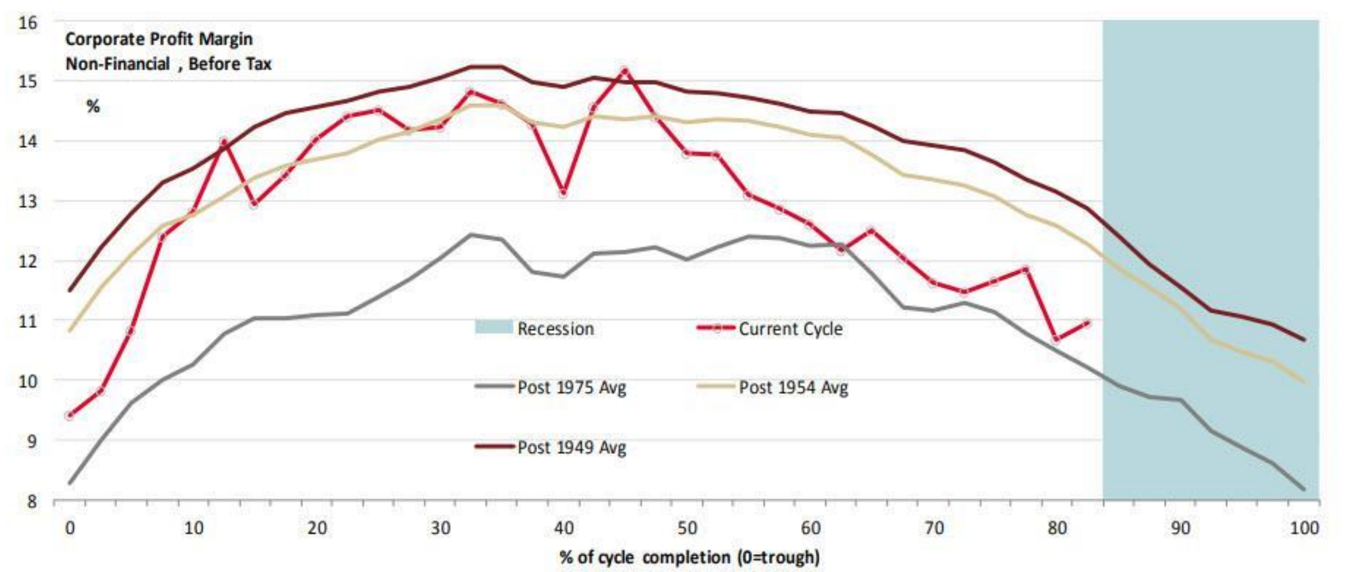
We'll see, but my expectation is based on a pattern that repeats over and over. The first few quarters of most recessions are what you could call the silent phase, in which the economy goes down, with increasing speed, yet everyone remains able to pretend it's all good. If Fasanara Capital is correct, far earlier than normal, one hiccup in a key corporate junk debt market, or one dramatic drop in key stocks, will immediately blow up the whole world financial system.

More Evidence of Recession

1. **Profit Margins**
   Odd as it may seem that any indicator could be better than all spending contracting (which is by definition economic contraction, or recession if it continues), to me even more certainty is found in corporate profit margins. The correlation between profit margins and the economy is one of the highest in economics. According to the chart below, we're about a month away from full-blown recession.

If you study enough recessions and economic indicators, you know profit-margins *always* revert to the mean, dragging the economy down with them. This happens pretty much like clockwork, which is why it is the single indicator many of us watch most closely to spot a recession.

The extent of the current US corporate margin squeeze is usually enough to trigger recession



Source: Steve Gallagher, SG US Economics

2. Finally, one of the more accurate leading indicators, by the Organization of Economic Development, has fallen for 21 straight months. It measures the world economy, which indeed has been suffering overall for quite a while now.

   The European Union will one day discover you can't fix financial insolvency through monetary policy. You can only prop it up until it falls over, as the historically high mountain of bad corporate loans never disappear until recognized. Until then they pull the economy down, and there is literally no way out of that trap, except to make somebody lose the money. That's called a very scary financial crisis.

   As for the rest of the world, to quote Dr. David Rosenberg's most recent report, "…Chinese economic activity has slowed to three-decade lows and India is losing momentum fast. Germany's manufacturing PMI remains in deep recession mode…"

I hope to be forgiven if a month early, but the downturn we are seeing in so many key parts of the economy, here and around the world, can only mean one thing. We have entered recession.